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USOECD

PASS: CEA, TREAS (VACCARA AND WIDMAN), FRB (AXILROD)

E.O. 11652: N/A
TAGS: OECD, ECON
SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF THE U.S.

REF: EDR(77)16

1. SUMMARY: AT JUNE 16 EDRC REVIEW OF THE U.S., U.S.
DEL (LED BY VACCARA, TREASURY) AND SECRETARIAT WERE IN
AGREEMENT THAT HEALTHY EXPANSION WAS VIRTUALLY ASSURED
OVER NEXT TWELVE MONTHS. THUS, DISCUSSION, GUIDED BY
FRENCH (CORTESE) AND CANADIAN (SLATER) EXAMINERS,
FOCUSED ON MEDIUM-TERM PROBLEMS OF ASSURING DURABILITY
OF EXPANSION AND REDUCING UNDERLYING RATE OF INFLATION
THROUGH POLICIES TO HELP INSURE ADEQUACY OF PRIVATE
INVESTMENT, AS WELL AS TO DAMPEN UPWARD PRESSURE ON
NOMINAL WAGES AND PRICES. U.S. TOOK ISSUE WITH SECRE-
TARIAT ANALYSIS IN REFD0C, WHICH CONCLUDED THAT EMER-
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GENCE OF SUPPLY BOTTLENECKS WAS PROBABLE IN NEAR TO
MEDIUM-TERM FUTURE AND THAT FULL CAPACITY MIGHT BE
REACHED BEFORE SIGNIFICANT FURTHER REDUCTION IN UNEMPLOY-
MENT COULD BE ACHIEVED. VACCARA PRESENTED COGENT ANALY-
SIS OF RECENT TRENDS IN STRUCTURE OF SUPPLY, DEMAND, AND
INVESTMENT WHICH CONVINCED SECRETARIAT THAT EMERGENCE OF
BOTTLENECKS WAS UNLIKELY, BUT SHE ADDED THAT INSUFFICIENT

INVESTMENT COULD BE SOURCE OF INFLATIONARY PRESSURE. U.S. (AXILROD) POINTED TO MISTAKEN IMPRESSION GIVEN IN REFDOC THAT CENTRAL OBJECTIVE OF U.S. MONETARY POLICY WAS ACHIEVEMENT OF GROWTH TARGETS FOR MONETARY AGGREGATES; THESE TARGETS WERE NOT ENDS IN THEMSELVES, BUT SUBSERVIENT TO OVERRIDING GOAL OF SECURING DESIRABLE PERFORMANCE OF THE ECONOMY. SEVERAL EDRC DELS STRESSED THAT SWING OF U.S. CURRENT ACCOUNT TOWARD DEFICIT SINCE 1975 HAD MADE IMPORTANT CONTRIBUTION TO BRINGING ABOUT SUSTAINABLE INTRA-OECD PAYMENTS PATTERN. U.S. (WIDMAN) STRESSED THIS CONTRIBUTION POLITICALLY DIFFICULT TO SUSTAIN WITHOUT MOVEMENT IN SIMILAR DIRECTION BY OTHER STRONG COUNTRIES. EDRC CONCLUDED THAT U.S. POLICY SHOULD AIM AT STIMULATING INVESTMENT AND REDUCING UNDERLYING RATE OF INFLATION OVER MEDIUM TERM. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: U.S. AND SECRETARIAT AGREED THAT CONTINUED, HEALTHY EXPANSION WAS VIRTUALLY ASSURED OVER THE TWELVE MONTHS TO MID-1978. U.S. NOTED THAT ACCELERATION OF ACTIVITY AFTER "PAUSE" IN MID-1976 HAD BEEN FUELED BY RESIDENTIAL CONSTRUCTION AND PRIVATE CONSUMPTION SPENDING, THE LATTER SPURRED BY SHARP DECLINE IN SAVINGS RATE. U.S. INDICATED THAT EXPECTED RISE IN SAVINGS RATIO WOULD REDUCE SUPPORTIVE ROLE OF PRIVATE CONSUMPTION IN BALANCE OF THIS YEAR, BUT THAT GROWTH OF PRIVATE NON-RESIDENTIAL INVESTMENT AND LIMITED OFFICIAL USE

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INCREASE IN SPENDING BY STATE AND LOCAL GOVERNMENTS SHOULD FILL IN GAP. THUS, REAL GNP WAS FORECAST TO RISE BY 5-3/4 - 6 PERCENT BETWEEN FOURTH QUARTER OF 1976 AND FOURTH QUARTER OF 1977.

3. U.S. EMPHASIZED THAT FUTURE GROWTH OF PRIVATE NON-RESIDENTIAL INVESTMENT CONSTITUTED MAIN UNCERTAINTY IN SHORT-RUN OUTLOOK AS WELL AS IMPORTANT RISK TO DURABILITY OF EXPANSION OVER MEDIUM TERM. UNCERTAINTY ON PART OF BUSINESS LIKELY TO MILITATE AGAINST INCREASED INVESTMENT, BUT SUCH UNCERTAINTY WAS RELATED NOT SO MUCH TO EXPECTED GROWTH OF DEMAND AS TO POSSIBLE IMPACT OF ENERGY PROGRAM, ENVIRONMENTAL REGULATIONS AND OF HEALTH/SAFETY STANDARDS. THUS, POLICIES SHOULD AIM AT CLARIFYING THESE VARIOUS REGULATIONS SO AS TO REDUCE BOTH UNCERTAINTY AND COSTS. MOREOVER, DESPITE CYCLICAL RECOVERY OF PROFIT RATES (PROFITS MEASURED AFTER NET TAXES AND INVENTORY PROFITS, WITH DEPRECIATION ON REPLACEMENT COST BASIS), DECLINING TREND OF REAL PROFITABILITY OF INVESTMENT WAS STILL IN EVIDENCE. TO REVERSE THESE TRENDS,

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POLICY MEASURES, IN ADDITION TO THOSE NOTED ABOVE,
WOULD BE APPROPRIATE TO INCREASE RATE OF RETURN ON AND
REDUCE COST OF CAPITAL. U.S. STATED THAT SUCH MEASURES
(SUCH AS ELIMINATION OF DOUBLE TAXATION OF DIVIDENDS)
COULD HAVE SALUTORY EFFECT OVER MEDIUM TERM, BUT
STRESSED THAT FORMULATION OF CONCRETE PROPOSALS IN THIS
AREA WAS AT HIGHLY PRELIMINARY STAGE.

4. IN CONTEXT OF INVESTMENT DISCUSSION, U.S. TOOK ISSUE
WITH SECRETARIAT VIEW THAT SUPPLY BOTTLENECKS COULD WELL
EMERGE IN NEAR TO MEDIUM-TERM FUTURE AND OBJECTED TO
SECRETARIAT'S COMPARING CURRENT SITUATION TO THAT WHICH
EXISTED IN 1973. U.S. EXPLAINED THAT (A) IN 1973,
THOSE INDUSTRIES AT FULL CAPACITY WERE CHARACTERIZED BY
CONTINUOUS PROCESSING PRODUCTION TECHNIQUES AND THUS HAD
NO FLEXIBILITY TO INCREASE PRODUCTION BY, FOR EXAMPLE,
ADDING EXTRA SHIFTS. PRESENTLY, CAPACITY UTILIZATION
RATES ARE HIGHEST IN INDUSTRIES WHICH DO HAVE SUCH FLEXI-
BILITY; (B) MANY PROBLEM INDUSTRIES IN 1973 (E.G., BASIC
MATERIALS) HAVE ALSO EXPERIENCED THE STRONGEST RATES OF
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INVESTMENT SINCE THAT TIME; PRODUCTION EXCEEDS 1973 LEVELS, BUT EXCESS CAPACITY IS ALSO GREATER. CONSEQUENTLY, PROBLEM IS NOT LIKELIHOOD OF BOTTLENECKS IN SENSE THAT KEY INDUSTRIES MAY BE UNABLE TO EXPAND PRODUCTION SUFFICIENTLY TO MEET DEMAND. HOWEVER, INSUFFICIENT AGGREGATE GROWTH OF CAPITAL STOCK COULD WELL LEAD TO COST AND PRICE PRESSURE SINCE (A) MORE INTENSIVE USE OF EXISTING CAPITAL STOCK (E.G., THROUGH MORE SHIFT WORK) IS EXPENSIVE AND (B) TO EXTENT TECHNOLOGICAL PROGRESS IS "CAPITAL EMBODIED," SLOW GROWTH OF INVESTMENT IMPLIES LOWER AVERAGE PRODUCTIVITY OF CAPITAL AND INCREASES PRODUCTION COSTS. SECRETARIAT WAS CONVINCED BY U.S. ARGUMENTS AND WILL REVISE DRAFT SURVEY ACCORDINGLY.

5. COSTS AND PRICES: DISCUSSION OF COSTS AND PRICES DOMINATED BY SIMPLE CALCULATION THAT 8 PERCENT (GROWTH COMPENSATION PER MAN HOUR) MINUS 2 PERCENT (TREND GROWTH OF PRODUCTIVITY) EQUALS 6 PERCENT (UNDERLYING RATE OF INFLATION). POLICY IMPLICATIONS OF ABOVE ARITHMETIC WERE FAR FROM SIMPLE. U.S. STRESSED DIFFICULTY OF EFFECTING REDUCTION IN UNDERLYING INFLATION RATE AND OUTLINED PRINCIPAL ELEMENTS OF ADMINISTRATION'S PROPOSED ANTI-INFLATION PROGRAM. THESE INCLUDE (A) CLARIFICATION OF ENVIRONMENTAL AND OTHER REGULATIONS; (B) INVESTMENT INCENTIVES; (C) COMMODITY RESERVES; (D) MORE VIGOROUS ENFORCEMENT OF ANTI-TRUST REGULATIONS; (E) REVIEW OF USG RATE-SETTING REGULATIONS (E.G., FOR AIRLINES); (F) FURTHER TRADE LIBERALIZATION; AND (G) INFORMAL CONSULTATIONS ON DESIRABLE ECONOMIC TRENDS AND OBJECTIVES AMONG GOVERNMENT, BUSINESS AND LABOR. U.S. STRESSED THAT REDUCTION OF UNDERLYING RATE OF INFLATION WOULD REQUIRE THREE-PRONGED APPROACH DESIGNED TO MODERATE GROWTH OF PRICES LIMITED OFFICIAL USE

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AND NOMINAL WAGES, WHILE ACCELERATING GROWTH OF PRODUCTIVITY.

6. UNEMPLOYMENT: U.S. NOTED THAT STRONG GROWTH OF EMPLOYMENT IN RECENT MONTHS HAD INDUCED DECLINE IN UNEMPLOYMENT RATE FROM 8 PERCENT IN NOVEMBER, 1976 TO 6.9 PERCENT IN MAY THIS YEAR. THUS, ADMINISTRATION'S GOAL OF LOWERING UNEMPLOYMENT RATE TO 6.75 PERCENT BY FOURTH QUARTER OF 1977 SEEMED ACHIEVABLE. U.S. QUESTIONED SECRETARIAT CONTENTION THAT FULL CAPACITY UTILIZATION MIGHT BE REACHED BEFORE FURTHER SIGNIFICANT FALL IN RATE OF UNEMPLOYMENT COULD BE ACHIEVED AND POINTED OUT THAT SIGNIFICANT PORTION OF LABOR FORCE GROWTH WAS ATTRIBUTABLE TO PART-TIME WORKERS. THUS, SUPPLY OF

LABOR COULD BE ACCOMMODATED WITH SLOWER GROWTH OF CAPITAL STOCK THAN WOULD BE THE CASE IF ALL NEW ENTRANTS INTO LABOR FORCE DESIRED FULL-TIME WORK. IN THIS CONNECTION, U.S. INDICATED THAT CHANGES IN COMPOSITION OF LABOR FORCE AND OTHER FACTORS HAD LED PREVIOUS ADMINISTRATION TO CONCLUSION THAT UNEMPLOYMENT RATE COULD BE LOWERED TO ONLY 5.5 PERCENT (VS. 4 PERCENT IN PAST) THROUGH USE OF DEMAND MANAGEMENT POLICIES ALONE. ALTHOUGH NOTING THAT PRESENT ADMINISTRATION HAD NOT YET DEVELOPED PRECISE ESTIMATE OF SUCH A "FULL EMPLOYMENT UNEMPLOYMENT RATE," U.S. TENTATIVELY SUGGESTED THAT IT MIGHT BE IN 5-5.5 PERCENT RANGE, AND EMPHASIZED NEED TO MARSHALL BROAD RANGE OF POLICIES TO EFFECT ITS REDUCTION.

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7. CURRENT ACCOUNT: SMALL COUNTRIES APPLAUDED \$24 BILLION SWING TOWARD DEFICIT OF U.S. CURRENT ACCOUNT BETWEEN 1975 AND POSITION EXPECTED FOR THIS YEAR. THEY STRESSED CONTRIBUTION THIS SWING HAD MADE TO BRINGING ABOUT SUSTAINABLE INTRA-OECD PAYMENTS PATTERN. U.S. NOTED THAT WHILE PORTION OF THIS SWING WAS ATTRIBUTABLE TO INCREASED OIL IMPORTS, NON-OIL IMPORTS SHOULD RISE BY 50 PERCENT (\$35 BILLION) BETWEEN 1975 AND 1977. IN RESPONSE TO QUESTION BY FRENCH (CORTESSE), U.S. NOTED

THAT IMPRESSION OF U.S. PUBLIC THAT OIL ACCOUNTED FOR MOST OF CURRENT ACCOUNT DEFICIT WAS PERHAPS USEFUL (ALTHOUGH MISTAKEN) IN THAT (A) IT STRENGTHENED SUPPORT FOR THE ADMINISTRATION'S ENERGY PROGRAM AND (B) IT MADE DEFICIT SOMEWHAT EASIER TO DEFEND. U.S. EMPHASIZED, HOWEVER, THAT IT WOULD BE INCREASINGLY DIFFICULT TO DEFEND DEFICIT DOMESTICALLY IN CIRCUMSTANCES WHERE OTHER STRONG COUNTRIES WERE IN PERSISTENT SURPLUS.

8. FISCAL AND MONETARY POLICY: U.S. STATED THAT FISCAL LIMITED OFFICIAL USE

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POSITION WAS UNLIKELY TO CHANGE VERY MUCH BETWEEN FY77 AND FY78. ON A NATIONAL ACCOUNTS BASIS, BUDGET DEFICIT SHOULD FALL BY ABOUT \$3 BILLION. SEVERAL DELS SOLICITED U.S. VIEWS ON POSSIBLE FACTORS UNDERLYING RECENT UNINTENDED SHORTFALLS IN FEDERAL GOVERNMENT SPENDING. U.S. REMARKED THAT REASON FOR SHORTFALLS WERE LARGELY A MISTERY TO US AS WELL; ASSUMPTIONS UNDERLYING U.S. OFFICIAL FORECASTS IS THAT SHORTFALLS WILL CONTINUE, IN FY1978, BUT AT A REDUCED RATE.

9. MONETARY POLICY: IN REFDOC DISCUSSION OF U.S. MONETARY POLICY, SECRETARIAT POINTED TO DIFFICULTY OF ADHERING TO TARGETED RANGES FOR GROWTH RATES OF MONETARY AGGREGATES AND NOTED THAT EFFORT TO DO SO COULD HAVE DESTABILIZING CONSEQUENCES FOR INTEREST RATES AND/OR COULD REQUIRE FREQUENT AND DRASTIC ADJUSTMENTS. U.S. OBJECTED TO IMPLICATION THAT PRIMARY GOAL WAS TO ENSURE GROWTH OF AGGREGATES CONSISTENT WITH ESTABLISHED RANGES AND EMPHASIZED THAT OVERRIDING OBJECTIVE WAS DESIRABLE PERFORMANCE OF THE ECONOMY. U.S. EXPLAINED THAT RANGES FOR GROWTH OF VARIOUS AGGREGATES ARE SET QUARTERLY FOR FOLLOWING YEAR, TAKING ACCOUNT OF SUCH FACTORS AS (A) EXPECTED TRENDS IN PRIVATE SECTOR; (B) JUDGEMENTS AS TO LIKELY FISCAL DEVELOPMENTS; AND (C) PAST MONETARY GROWTH AND OVERALL CREDIT CONDITIONS. DESIRABLE PERFORMANCE OF ECONOMY WOULD BE CONSISTENT WITH FREQUENT CHANGES IN GROWTH RATE OF MONEY SUPPLY WHEN SUCH SHIFTS ARE EFFECTED TO OFFSET INSTABILITY ELSEWHERE IN THE ECONOMY. SECRETARIAT TOOK U.S. EXPLANATION TO HEART AND WILL MAKE APPROPRIATE CHANGES IN REVISED DRAFT SURVEY.

10. MAIN EDRC CONCLUSION WAS THAT USG SHOULD ACT VIGOR- LIMITED OFFICIAL USE

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OUSLY TO REDUCE UNDERLYING RATE OF INFLATION AND TO
STIMULATE GROWTH OF INVESTMENT.
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